DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER 04-0353P TAX ADMINISTRATION (USE TAX)— NEGLIGENCE PENALTIES FOR THE REPORTING PERIODS COVERING CALENDAR YEARS 2001-03

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the *Indiana Register* and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the *Indiana Register*. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Tax Administration—Negligence Penalties—Audit Deficiencies—Ignorance of Law

Authority: IC §§ 6-8.1-5-1(b) and -10-2.1 (2004); 45 IAC §§ 15-5-3(b)(8) and -11-2 (2004)

II. Tax Administration—Negligence Penalties—Audit Deficiencies (Use Tax)—Reliance on Vendor's Representation It Would Pay Sales Tax—Burden of Proof

Tax Administration—Negligence Penalties—Audit Deficiencies (Use Tax)—Purchaser's Constructive Knowledge of Liability for Use Tax on Interstate Purchases

Authority: IC §§ 6-2.5-3-4(a)(1) and -5 (1998) (current respective versions at *id.* (2004)); IC §§ 6-8.1-5-1(b) and -10-2.1 (2004); *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359, 363 (1941); *Ind. Dep't of State Rev. v. Trump Ind. Inc.*, 814 N.E.2d 1017, 1019 (Ind. 2004); *State v. Huffman*, 643 N.E.2d 899, 900 (Ind. 1994); *Peabody Coal Co. v. Ralston*, 578 N.E.2d 751, 754 (Ind. Ct. App. 1991); *Porter Mem'l Hosp. v. Malak*, 484 N.E.2d 54, 58 (Ind. Ct. App. 1985); *Morton Bldgs., Inc. v. Ind. Dep't of State Rev. (Morton Bldgs. VII)*, 819 N.E.2d 913, 915 (Ind. Tax Ct. 2004), *review denied* 831 N.E.2d 744 (Ind. 2005) (table); *Canal Sq. Ltd. Partnership v. State Bd. of Tax Comm'rs*, 694 N.E.2d 801, 804 (Ind. Tax Ct. 1998); *Longmire v. Ind. Dep't of State Rev.*, 638 N.E.2d 894, 898 (Ind. Tax Ct. 1994); *USAir, Inc. v. Ind. Dep't of State Rev.* (*USAir II*), 623 N.E.2d 466, 468-69 (Ind. Tax Ct. 1993); *Morton Bldgs., Inc. v. Comm'r of Revenue*, 683 N.E.2d 720, 722 (Mass. App. Ct. 1997); *Bullock v. Foley Bros. Dry Goods Corp.*, 802 S.W.2d 835, 839 (Tex. App. 1990); 45 IAC § 2.2-3-20 (1996) (2001) (current version at *id.* (2004)); 45 IAC §§ 15-3-2(e), -5-3(b)(8) and -11-2 (2004); 68 Am. Jur. 2d *Sales and Use Taxes* § 168 (2004); BLACK'S LAW

DICTIONARY 190 (7th ed. 1999) ("burden of persuasion" and "burden of proof")

III. Tax Administration—Negligence Penalties—Audit Deficiencies—Good Filing History

Authority: IC §§ 6-8.1-5-1(b) and -10-2.1 (2004); *State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.*, 765 N.E.2d 1257, 1264 (Ind. 2002); *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs*, 715 N.E.2d 1018, 1024 and 1024-25 (Ind. Tax Ct. 1999); 45 IAC §§ 15-5-3(b)(8) and -11-2 (2004)

The taxpayer protests the Audit Division's proposed assessment of negligence penalties.

STATEMENT OF FACTS

The Department's Audit Division conducted a field audit of the taxpayer for the tax type and reporting periods set out in the heading of this Letter of Findings. As a result of the audit, the taxpayer incurred tax deficiencies. The Audit Division proposed assessing, and the taxpayer has protested only proposed assessment of, negligence penalties. Since filing this protest, the taxpayer has petitioned one of the federal bankruptcy courts sitting in Indiana for reorganization under 11 U.S.C. Chapter 11 (2000 and Supp. V 2005), and the Department has filed a proof of claim in that case for all liabilities owed it, including the negligence penalties. The Department will provide additional information as needed.

I. Tax Administration—Negligence Penalties—Audit Deficiencies—Ignorance of Law

DISCUSSION

A. TAXPAYER'S ARGUMENT

The taxpayer failed to accrue and remit use tax on licenses for new software on which its licensors/vendors did not charge it gross retail (sales) tax. The taxpayer submits that one reason the Department should waive the negligence penalties is that the taxpayer was not aware of the specific guidelines on software licenses. In particular, the taxpayer alleges that these failures occurred due to a mistaken belief that two of the software packages it licensed were tax-exempt "custom" software. This latter allegation also implies that the taxpayer did not correctly understand, i.e. that it was ignorant of, this Department's longstanding interpretation of what constitutes taxable "canned" software.

B. ANALYSIS

IC § 6-8.1-10-2.1 (2004) is the statute that authorizes the Department to impose a penalty for any negligence of a taxpayer in failing to comply with the tax laws that the Department administers. These taxes are listed in IC § 6-8.1-1-1 and include the gross retail and use tax. IC § 6-8.1-10-2.1(a)(3) states that "(a) [i]f a person: … (3) [i]ncurs, upon examination by the department, a

deficiency that is due to *negligence*; … the person is subject to a penalty." *Id.* (Emphasis and alterations added). The amount is set by IC § 6-8.1-10-2.1(b)(4), which states that "(b) [e]xcept as provided in subsection (g) [,] [not in issue here], the penalty described in subsection (a) is ten percent … of: … (4) the amount of deficiency as finally determined by the department[.]" *Id.* (Alterations added.) However, IC § 6-8.1-10-2.1(d) states that "[i]f a person subject to the penalty imposed under this section can show that the failure to … pay the deficiency determined by the department was due to *reasonable cause* and not due to willful neglect, the department shall waive the penalty." *Id.* (Emphasis and alteration added).

Title 45 IAC § 15-11-2(b) states:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's *carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence.* Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

Id. (Emphasis added.) The next subsection of the regulation sets out the standard of care a taxpayer must prove pursuant to IC § 6-8.1-10-2.1(e) to establish reasonable cause for failing to meet its tax compliance duties to the Department. Subsection (c) of 45 IAC § 15-11-2 reads in relevant part as follows:

> (c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 [sic][should read IC 6-8.1-10-2, repealed and re-enacted in 1991 as IC 6-8.1-10-2.1] if the taxpayer affirmatively establishes that the failure to…pay a deficiency was due to reasonable cause and not due to negligence. *In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section ….*
>
> …
>
> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Id. (Emphasis and alterations added.)

Under IC § 6-8.1-5-1(b) (2004) and 45 IAC § 15-5-3(b)(8) (2004), the person against whom a

proposed assessment is made has the burden of proving that it is wrong. That burden applies to abatement of penalty assessments, as well as substantive tax assessments. *"A person who wishes to avoid the penalty imposed under [IC § 6-8.1-10-2.1(a) and (b)] must make an affirmative showing of all facts alleged as a reasonable cause* for the person's failure to file the return, pay the amount of tax shown on the person's return, pay the deficiency, or timely remit tax held in trust[.]" IC § 6-8.1-10-2.1(e) (emphasis and alterations added). The burden of proof is not on the Department to show negligence, willful or otherwise, by, or the absence of reasonable cause for the actions or inaction of, a taxpayer.

The taxpayer's argument is in effect that it did not know it was liable for use tax on the software licenses on which the Audit Division ultimately proposed to assess the audit deficiencies against it. The taxpayer thus has admitted that it was "ignoran[t] of the listed tax laws, rules and/or regulations[,][which] is treated as negligence. " 45 IAC § 15-11-2(b) (alterations added). Such ignorance is not an exercise of "ordinary business care and prudence[,]" *id.*(c), and therefore does not establish reasonable cause under IC § 6-8.1-10-2.1(d) and 45 IAC § 15-11-2(c) to waive the proposed negligence penalties.

FINDING

The taxpayer's protest is denied to the extent it is based on this issue.

II. Tax Administration—Negligence Penalties—Audit Deficiencies (Use Tax)—Reliance on Vendor's Representation It Would Pay Sales Tax—Burden of Proof

Tax Administration—Negligence Penalties—Audit Deficiencies (Use Tax)—Purchaser's Constructive Knowledge of Liability for Use Tax on Interstate Purchases

DISCUSSION

A. TAXPAYER'S ARGUMENT

At the end of the term of an equipment lease, the taxpayer exercised an option thereunder to buy the leased equipment, consisting of computer checkout monitors, hardware, electronic scales, printers and associated software. The taxpayer alleges that the lease agreement had language in it to the effect that the purchase price would include sales tax. However, the taxpayer also admits that the invoice it received for the purchase did not have a line item for the sales tax. The lessor/vendor was located outside Indiana and is not authorized to do business in Indiana according to the online records of the Business Services Division of the Indiana Secretary of State's office. The field auditor adjusted the taxpayer's liability on this purchase by assessing use tax pursuant to 45 IAC § 2.2-3-20 (1996) (2001) (current version at *id.* (2004)). The taxpayer has not submitted copies of either the equipment lease or the purchase invoice in evidence in this protest.

B. ANALYSIS

1. The Taxpayer Has Failed to Sustain Its Burden of Proof of Reasonable Cause for Its Failure to Remit Use Tax on the Equipment Purchase.

As previously discussed, a taxpayer has the burden of proof in a protest. IC § 6-8.1-5-1(a) states that "[t]he burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.") *Id. See also* BLACK'S LAW DICTIONARY 190 (7th ed. 1999) (defining "burden of proof" as a "party's duty to prove a disputed assertion or charge"). The burden of proof is two-fold, consisting of both the burden of persuasion and the burden of production. *Porter Mem'l Hosp. v. Malak*, 484 N.E.2d 54, 58 (Ind. Ct. App. 1985) (noting that "burden of proof" is not a precise term, as it can mean both the burdens of persuasion and production).

The terms "burden of production" and "burden of persuasion" have two distinct meanings. *See State v. Huffman*, 643 N.E.2d 899, 900 (Ind. 1994) (stating that there are "two senses" of the term "burden of proof," the burdens of persuasion and production). The burden of production, also referred to as the burden of going forward, is the taxpayer's "duty to introduce enough evidence on an issue to have the issue decided by the fact-finder." *Id.* In other words, a taxpayer must submit evidence sufficient to establish a prima facie case, i.e., evidence sufficient to establish a given fact and which if not contradicted will remain sufficient to establish that fact. *See Longmire v. Ind. Dep't of State Rev.*, 638 N.E.2d 894, 898 (Ind. Tax Ct. 1994); *Canal Sq. Ltd. Partnership v. State Bd. of Tax Comm'rs*, 694 N.E.2d 801, 804 (Ind. Tax Ct. 1998). *Cf. Bullock v. Foley Bros. Dry Goods Corp.*, 802 S.W.2d 835, 839 (Tex. App. 1990) (observing, in challenge to state's sales and use tax audit, that comptroller's deficiency determination is prima facie correct and that taxpayer must disprove it with documentation). In penalty protests in particular, it is to the burden of production that IC § 6-8.1-10-2.1(e) speaks when it states that the penalized person "must make an affirmative showing of all *facts* alleged as a reasonable cause for the person's failure to" comply with the listed tax laws. *Id.* (Emphasis added).

In contrast to the burden of production component of the burden of proof, the burden of persuasion is the taxpayer's "duty to convince the fact-finder to view the facts in a way that favors that party. … Also loosely termed *burden of proof*." BLACK'S LAW DICTIONARY 190 (7th ed. 1999) (emphasis in original.) Some cases have referenced this dual meaning. *See, e.g., Peabody Coal Co. v. Ralston*, 578 N.E.2d 751, 754 (Ind. Ct. App. 1991) (observing that in criminal cases, the "State carries the ultimate burden of proof, or burden of persuasion").

The present taxpayer has failed to meet its burden of production in that it has failed to submit any evidence concerning the lessor/vendor's alleged representation that it would pay the sales tax. Specifically, it has failed to submit either a copy of the lease purchase agreement which allegedly contains representation/s concerning sales tax being included in the purchase price or a copy of the invoice which it alleges had no line item entry for sales tax. The taxpayer has also failed to meet its burden of persuasion that this part of the negligence penalties should be waived, since there is no evidence, and therefore no established facts, in the record to which the burden of persuasion could apply.

2. The Taxpayer Had Constructive Knowledge It Is Liable for Use Tax on Interstate Purchases of Tangible Personal Property Brought to Indiana, and Therefore to Have Known It Was Liable for Use Tax on the Equipment Purchase.

However, even if the Department were to assume, without necessarily finding, that there was no sales tax line item on the alleged invoice, the absence of such an entry would undercut the taxpayer's argument. The taxpayer is charged with constructive knowledge of 45 IAC § 2.2-3-20, which reads in pertinent part as follows:

> Sec. 20. All purchases of tangible personal property which are delivered to the purchaser for storage, use, or consumption in the state of Indiana are subject to the use tax. … If the seller is not required to collect the tax or fails to collect the tax when required to do so, the purchaser must remit the use tax directly to the Indiana Department of Revenue.

Id. The regulation is consistent with the nationwide general legal view as to the place and role of the use tax in state and local tax systems and the circumstance under which liability for that tax accrues to the jurisdiction in which the property becomes located. As pointedly expressed in one opinion, "*[t]he use tax* is complementary to the sales tax and *bites when the sales tax does not.*" *Morton Bldgs., Inc. v. Comm'r of Rev.*, 683 N.E.2d 720, 722 (Mass. App. Ct. 1997) (emphases and alteration added), *paraphrased and followed in Morton Bldgs., Inc. v. Ind. Dep't of State Rev. (Morton Bldgs. VII)*, 819 N.E.2d 913, 915 (Ind. Tax Ct. 2004), *review denied* 831 N.E.2d 744 (Ind. 2005) (table). This rule follows from the well-settled general law in this country on the purpose and function of a use tax. "It [has long been] one of the well-known functions of the integrated use and sales tax to remove the buyers' temptation to place their orders in other states in the effort *to escape payment of the tax on local sales*." *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359, 363 (1941) (internal quotation marks omitted) (emphasis and alteration added). In addition to the United States Supreme Court, at least ten courts sitting in jurisdictions other than Indiana have reported opinions discussing this subject and taking the same view. Their consensus, summarized in a secondary source, is that "[t]he use tax is correlative of, and is complementary and supplemental to, the sales tax, *one of its principal purposes being to prevent the evasion of the sales tax.*" 68 Am. Jur. 2d *Sales and Use Taxes* § 168 (2004) (footnote omitted) (emphasis and alteration added).

Morton Buildings VII, cited above, makes it clear that Indiana is in the judicial mainstream regarding the function and role of the use tax. The Indiana Supreme Court settled the law and removed any doubt that might have lingered on this point less than three months before the Indiana Tax Court issued *Morton Buildings VII. See Ind. Dep't of State Rev. v. Trump Ind. Inc.*, 814 N.E.2d 1017, 1019 (Ind. 2004). Admittedly, neither opinion was issued until after the close of the taxpayer's audit period. However, it did have the benefit of the first reported Indiana opinion, issued well before that period began, that made the same point:

> Like most states, Indiana has complementary sales and use taxes. *See* IND.

> CODE 6-2.5-3-4(a)[(1)] [(1988) (audit period and current versions at *id.* (1998) and (2004), respectively) (exempting the storage, use and consumption of tangible personal property in Indiana from use tax if Indiana sales tax was paid when that property was acquired)]. … *The complementary formulation exists to ensure non-exempt retail transactions that escape sales tax liability are nonetheless taxed.*

USAir, Inc. v. Ind. Dep't of State Rev. (*USAir II*), 623 N.E.2d 466, 468-69 (Ind. Tax Ct. 1993) (citation omitted) (emphasis and alterations added). Title 45 IAC § 2.2-3-20, which was in effect when the Tax Court issued *USAir II* and on which the present taxpayer's auditor relied, is to the same effect as regards interstate transactions. *But cf.* IC § 6-2.5-3-5 (1998) (current version at *id.* (2004)) (granting a credit against use tax for any sales, purchase or use tax paid to another state-level taxing jurisdiction when the tangible personal property was acquired).

The lessor/vendor of the present taxpayer failed to collect and remit sales tax on its purchase of the equipment. It is no defense to the proposed negligence penalty assessments to say, as the taxpayer implies in its protest letter, that the vendor should have done so. The taxpayer knew it was dealing with an out-of-state lessor/vendor, and the absence of a sales tax line item on the purchase invoice should have been a red flag alerting the taxpayer to self-assess, report and remit use tax on that purchase. The taxpayer should have known that if it did not pay sales tax on a non-exempt purchase of tangible personal property later placed in Indiana, the taxpayer would owe use tax to Indiana. The taxpayer nevertheless failed to recognize, report and pay that liability, thereby incurring the part of the present audit deficiencies attributable to that failure, which was due to carelessness. That failure constituted "negligence" as defined in 45 IAC § 15-11-2(b). It is not evidence of an "exercise[ ] [of] ordinary business care and prudence[,]" 45 IAC § 15-11-2(b) (alterations added), and therefore is not "reasonable cause" under IC § 6-8.1-10-2.1(d) and (e) to waive the negligence penalties for the taxpayer's incurring the part of those deficiencies arising from the equipment purchase.

FINDING

The taxpayer's protest is denied to the extent it is based on this issue.

III. Tax Administration—Negligence Penalties—Audit Deficiencies—Good Filing History

DISCUSSION

A. TAXPAYER'S ARGUMENT

The taxpayer submits that another reason the Department should waive the negligence penalties is that it files all of its sales and use tax returns and pays all of those taxes on time.

B. ANALYSIS

The taxpayer's argument is in effect that it exercised ordinary care and prudence in filing its

returns with this Department, thereby implying that it had "reasonable cause," as 45 IAC § 15-11-2(c) defines that term, for its incurring audit deficiencies. That argument does not support the taxpayer's protest because it does not address the basis on which the negligence penalties were proposed against it. The taxpayer was not penalized by the Compliance Division under IC § 6-8.1-10-2.1(a)(1) or (2) for failing to file returns, for failing to file returns on time, or for failing to pay the full amount of tax shown on those returns. It was penalized by the Audit Division under IC § 6-8.1-10-2.1(a)(3) for "[i]ncur[ring], upon examination by the department, a deficiency that is due to negligence[.]" *Id.* (Alterations added.) The fact that the taxpayer filed its returns promptly and paid all the tax it reported has no tendency to prove that the present deficiencies, resulting from its omissions of tax from those returns, were incurred for reasonable cause. The taxpayer has therefore failed to sustain its burden of proof concerning the proposal of the negligence penalties to the extent it has based its protest on this ground.

FINDING

The taxpayer's protest is denied.

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